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No. 89-255

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA,
Petitioner,
vs.
ENERGY RESOURCES CO., INC.,

UNITED STATES OF AMERICA,
Petitioner,
vs.
NEWPORT OFFSHORE, LTD.,

ON WRITS OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

BRIEF OF GLK, INC. AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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BRIEF FOR GLK, INC., AMICUS CURIAE

STATEMENT OF INTEREST

GLK, Inc. is a debtor operating under a plan of reorganization approved by the Bankruptcy Court for the

Central District of California. GLK's plan contained a provision which, like that of Newport Offshore Ltd., provided that payments to the Internal Revenue Service be applied first to reduce its liability for "trust fund" taxes. That provision was ordered stricken by the court which felt compelled to follow the opinion of the Ninth Circuit Court of Appeals in *In re Technical Knockout Graphics*, 833 F.2d 797 (9th Cir. 1987), which held that payments to the Internal Revenue Service by a Chapter 11 debtor prior to confirmation of its plan of reorganization were "involuntary" and that therefore neither the debtor nor the court could direct how such payments should be applied. The Bankruptcy Court's order was appealed to the Bankruptcy Appellate Panel, affirmed, and is currently the subject of an appeal pending with the Ninth Circuit Court of Appeals in *In re GLK, Inc.*, No. 89-55196 (9th Cir.).

All parties have consented to the filing of this brief and letters indicating such consent have been filed with the Clerk.

SUMMARY OF ARGUMENT

Recent disputes over the allocation of tax payments have focused on whether the payments should be labelled "voluntary" or "involuntary" because of the *assumed* validity of a rule allowing tax debtors to designate application of "voluntary" payments and the Internal Revenue Service ("I.R.S.") to apply "involuntary" payments as it chooses. Courts have *incorrectly assumed* without question that such a dichotomy reflected the common law rule. As a result, there has been consistent heated litigation over the labelling question in the Chapter 11 bankruptcy context. Below, the First Circuit Court of Appeals accepted the I.R.S.'s use of the "voluntary-involuntary dichotomy" for purposes of its own

rules, but held that the courts were not bound by those rules and could order the I.R.S. to follow the designation made by the debtor.

The "voluntary-involuntary dichotomy" does *not* reflect the common law of this country. Instead it is a distortion of the longstanding and workable common law rules. The dichotomy should be laid to rest and the common law rules should be properly revived.

Under common law rules applied for over 100 years, debtors have had the right to designate how payments are to be applied among two or more debts owed to the same creditor. The right to make the allocation devolves upon the creditor only if, when and to the extent the creditor receives the payment unencumbered by any allocation. When and to the extent courts become vested with control over a debtor's property, the court has the authority to make such allocation according to its notions of justice. Although the terms "voluntary" and "involuntary" were used to describe payments, neither debtors *nor* creditors had the right to control application of payments described as "involuntary," in which case the right devolved upon the court having control of the property. Under those common law principles, the labelling question contributes nothing to an allocation dispute between debtor and creditor. The critical determinant underlying the allocation rules has been the property right of control and extent to which a debtor has been divested of that property right of control over the money or property. The right to designate how a debtor's property will be applied, being in the nature of "control" over the property, has followed the other property rights of that debtor. The ability of a taxpayer to designate how payments to the I.R.S. are to be applied as among various tax debts is rooted in the same common law. No special tax law or policy abrogates the common law rules or tax debtors' rights in that regard.

In a Chapter 11 bankruptcy, a debtor in possession retains practical control over its property, subject to court review. Upon confirmation of a plan of reorganization, all assets are vested back in the debtor, subject to his compliance with the plan. There is no legitimate reason or authority for denying reorganized debtors the ability to exercise a long-standing common law right and giving it to the I.R.S. If, under some theory, a debtor loses his "control" right to designate the application of his funds in bankruptcy, that right would be lost or surrendered to the court and/or any trustee, not the creditors. Likewise any allocation of tax payments would then be made by the court or trustee, not the I.R.S. as creditor. Thus, the bankruptcy court order requiring I.R.S. application of tax payments as designated by the debtors was proper and should be upheld, although based on a different analytical approach.

The imposition of personal liability on responsible corporate officers for unpaid trust fund taxes under the Internal Revenue Code does not reflect a policy inconsistent with a debtor's exercise of longstanding common law rights. The I.R.S. perceived potential for debtors abusing that right does not warrant abolishing it, especially when its exercise is already subject to judicial scrutiny in the Chapter 11 context. The policy suggested by the imposition of liability on responsible officers is that trust fund taxes be collected above all else, and it is those very taxes which the debtors here seek to pay, not avoid. Thus the substantive exercise of the debtors' rights here is entirely consistent with the policies reflected in the statute and should be upheld.

ARGUMENT

I RECENT DECISIONS ADDRESSING THE ISSUE OF PAYMENT APPLICATIONS IN THE TAXATION CONTEXT HAVE UNWITTINGLY APPLIED THE WRONG RULE OF LAW. THE I.R.S. NOW URGES THIS COURT TO DO THE SAME.

Recent disputes over whether the taxpayer/debtor or the Internal Revenue Service ("I.R.S.") has the right and authority to designate how payments to the I.R.S. will be applied among tax debts when made by a debtor in reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C.) have primarily focused on whether the payments should be labelled "voluntary" or "involuntary." That focus is the result of the unquestioned application of an I.R.S. "rule" that "permits taxpayers to designate the application of 'voluntary' tax payments, but [that] 'involuntary' payments are applied according to the I.R.S.'s own determination." Brief for Petitioner [United States/I.R.S.] at 19-20. That "rule" (that a debtor may designate how "voluntary" payments are to be applied, and that the I.R.S. is free to apply "involuntary" payments as it wishes) is referred to in this brief as the "voluntary-involuntary dichotomy," or sometimes as the "dichotomy." Below, the I.R.S. claimed that the dichotomy reflects the common law policy, however, the Court of Appeals did not question that claim. *Energy Resources*, 871 F.2d at 227. Despite the fact that the dichotomy neither reflects the common law rule nor is generally recognized outside the taxation context, no court has questioned its validity or the propriety of its application. *See, e.g., In re DuCharmes & Company*, 852 F.2d 194,

196 (6th Cir. 1988), ("...payments made to the I.R.S. on pre-petition tax liabilities by a Chapter 11 debtor ought to be considered 'involuntary payments' that may not be allocated [by the debtor]..."), *In re Ribs-R-Us, Inc.*, 828 F.2d 199, 201 (3d Cir. 1987), ("Ribs-R-Us does not challenge the proposition that its entitlement to designate payments depends on whether we view the payments as voluntary."), *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797, 801 (9th Cir. 1987), ("The issue here is whether payment of taxes after the debtor has filed a petition for reorganization under Chapter 11, but prior to confirmation of the reorganization plan, is voluntary.").

Below, the First Circuit Court of Appeals similarly accepted the validity of the dichotomy and its application by the I.R.S. when applying its own regulations, but further held that bankruptcy courts have the authority to order the I.R.S. to apply payments in a manner inconsistent with the I.R.S. proposed allocation. *In re Energy Resources Co., Inc.*, 871 F.2d 223 (1st Cir. 1989).

The "voluntary-involuntary dichotomy" does *not* reflect the long-standing common law rules and is not the proper rule to apply at all. By applying the dichotomy, the I.R.S. usurps power and authority neither recognized by the common law for creditors generally nor granted it specifically by statute.

II THE APPLICABLE COMMON LAW VESTS THE RIGHT TO DIRECT PAYMENT APPLICATION IN THE PERSON WHO CONTROLS THE FUNDS AT THE TIME OF PAYMENT. SINCE NOTHING IN THE BANKRUPTCY CODE OR THE INTERNAL REVENUE CODE SHIFTS THAT RIGHT TO THE I.R.S., THE COURT BELOW CORRECTLY AFFIRMED THE BANKRUPTCY COURT ORDERS THAT THE I.R.S. FOLLOW THE DEBTOR DESIGNATIONS.

A. Historical rules grant debtors the right to designate how payments are to be applied among debts. Under the common law, a debtor's right to designate how payments will be applied among debts is lost only when the money or property is lost. When control over property is surrendered by a debtor to the court, the right to designate the application of that property likewise devolves upon the court, not the creditor.

The general rule of law in this Country regarding application of payments is well settled that:

> "... the debtor or party paying the money may, if he chooses to do so, direct its appropriation; if he fail, the right devolves upon the creditor; if he fail, the law will make the application according to its own notions of justice. Neither of the parties can make it after a controversy upon the subject has arisen between them, and *a fortiori* not at the trial."

National Bank of the Commonwealth v. Mechanics' National Bank, 94 U.S. 437, 439 (1876), citing *United States v. Kirkpatrick*, 22 U.S. (9 Wheat.) 720 (1824), *United States v. January*, 11 U.S. (7 Cranch) 572 (1813), and *Field v. Holland*, 10 U.S. (6 Cranch) 8 (1810). *See also*, *First Nat. Bank in Palm Beach v. United States*, 591 F.2d 1143, 1147 (5th Cir. 1979), citing, among other authorities, *Tayloe v. Sandiford*, 20 U.S. (7 Wheat.) 7, 9-

10 (1822). The applicability or logic of the general rule has not been questioned in any relevant decision.

The logic and justice of the traditional rule is rooted in the simple right to control one's own property. *See, e.g., Bank of California v. Webb*, 94 N.Y. 467, 472 (1884), where the court stated:

> "A debtor paying money to a creditor to whom he owes several debts may direct the application of the payment because the money is his and he may do as he will with it and control its application. But the debtor must exercise his option as to the application when he makes the payment. After that the money has ceased to be his and is no longer subject to his control. Then it belongs to the creditor, and he is master of it, and may control its application... But if neither party makes any application of the payment and the matter comes into court, then the court will make such application of the payment as equity and justice require."

See, also, 40 AM. JUR. *Payment* §110 at p. 792. The rule's roots in the concept of control continue to be recognized in recent cases. *See, e.g., Federal Land Bank v. Wilson*, 719 F.2d 1367, 1371 (8th Cir. 1983), ("A debtor desiring to avail himself of his right to direct the application of a payment must give the direction therefor either before or at the time of payment; otherwise, the right is lost, because thereafter the money ceases to be his, and is no longer subject to his control.").

The use of terms regarding volition in this context is not new. However that use neither reflects nor supports application of the voluntary-involuntary dichotomy used by the I.R.S. and applied without question in recent decisions. Under early authorities, the creditor's right to designate how payments would be applied upon the debtor's failure to do so was as dependent on so-called

"voluntary" payments as was the debtor's right. *See, e.g.*, 40 AM. JUR. *Payment* §109 at p. 791 and §111 at p. 793, citing *Orleans County Nat. Bank v. Moore*, 112 N.Y. 543, 20 N.E. 357 (1889) for the proposition that "[t]he right of a debtor to make an application of a payment, or, in the event of his failure to do so, the right of a creditor to make such an application, may be exercised only in cases of voluntary payment." Thus, the labelling question, considered so important in recent disputes, contributes nothing to the analysis suggested by traditional wisdom.

Later works continued to recognize and describe the limitation on application of payments by both debtors and creditors, saying "In [cases involving involuntary payments, such as resulting from execution or judicial sales,] neither the debtor nor the creditor has a right to make an application..." 70 C.J.S. *Payment* §37 at p. 33, citing *Safe Deposit & Trust Co. v. Woodbridge*, 184 Md. 560, 42 A.2d 231 (1945), which itself relied upon *Orleans County Nat. Bank v. Moore*. *See also*, 60 AM. JUR.2D *Payment* §103, p. 948, which cites *Orleans County Nat. Bank v. Moore, First Nat. City Bank v. Kline*, 439 F.Supp. 726 (S.D.N.Y. 1977), and *Safe Deposit & Trust Co. v. Woodbridge*, both of the last two of which themselves rely on the first. Since *Orleans County Nat. Bank v. Moore* appears, directly or indirectly at the foundation of references to volition, an analysis of that case is appropriate to determine the significance of volition in this context.

Orleans County Nat. Bank v. Moore involved the right of a creditor to apply as it wished the proceeds of a judicial foreclosure sale among three separate obligations secured by a mortgage. The defendant Moore was secondarily liable on two of the three obligations. The court held that the application of the payments was to be made by the court, not the creditor, saying:

> " The right of a creditor to apply a payment made to him by a debtor, in the absence of any application by the debtor, seems to be confined to cases of voluntary payments. [citation omitted]...
> " So, in this case, if the mortgagor, by the condition in the mortgage, did not make an application of the moneys which might arise from a sale of the mortgaged premises to any particular debt, such moneys having arisen from a foreclosure and sale of the premises, and coming into the hands of the plaintiff (through the sheriff) by reason thereof, and in a judicial proceeding, their application would properly be made by the court, and upon equitable principles." *Orleans County Nat. Bank v. Moore*, 20 N.E. at 359.

The debtor's lack of volition precluded any creditor right to apply the payment as well as any debtor right. It is apparent that the term "voluntary" was not used as a criterion for debtor application, but to describe the presence of control. The essence of control as the true determinant is further underscored by the court's reference to a note on the cases of *Mayor et al. v. Patten*, 8 U.S. (4 Cranch) 317 (1807), and *Field v. Holland*, 10 U.S. (6 Cranch) 8 (1810), expressing that:

> "... the general principle of the common law is that the ownership of money determines the right of appropriation; and after it is paid, the debtor can make none." *Orleans County Nat. Bank v. Moore*, 20 N.E. at 364.

The Court went on to say:

> "It would seem that in cases of payment *in invitum*, or by judicial proceedings, the creditor does not become the owner of the money until it is paid, and the law at the very time of the payment

> makes its own application, and the creditor has no opportunity to make it himself."

Id. The above statement has been accepted as a proper description of the common law. *See*, 40 AM.JUR. *Payment*. §139 at p. 811 (citing *Orleans County Nat. Bank v. Moore*). The logic is clear and consistent: the property (and the concomitant right of control over it) was divested from the debtor in the foreclosure action and subjected to the jurisdiction (and therefore control) of the court. The issue decided was how the court would exercise its control in allocating the payment. After reviewing both English and American authorities, the court exercised its discretion and applied the monies *pro rata* among all three debts.

That the common law rule is alive outside the context of taxation is evident from its modern application; for example, by a Federal district court's application of non-tax payments previously made under bankruptcy court order. *First Nat. City Bank v. Kline*, 439 F.Supp. 726 (S.D.N.Y. 1977). There, a bank sought payment from a guarantor of one of several debts owed to it by a bankrupt debtor. Pursuant to the bankruptcy (apparently a liquidation), an undesignated part payment had been made to the bank. In the action on the guaranty, one of the guarantor's defenses was that the part payment received by the bank should have been applied to the guaranteed debt. The bank, in a position analogous to that of the I.R.S. here, took a contra position. The court held that "[w]here, as here, moneys are repaid under judicial order, the court has exclusive authority to apply the funds, and its application must be structured as "equity and justice require." *Id.* at 729, citing *Bank of California v. Webb*, 94 N.Y. 467, 472 (1884) and *Orleans County Nat. Bank v. Moore*, 112 N.Y. at 548, 20 N.E. at 359. The court went on to apply the payment *pro rata* among all the debts.

The voluntary-involuntary dichotomy, which gives creditors the automatic right to determine the application of payments to which the "involuntary" label is attached, is *not* a product of the longstanding common law.

The question then is whether the common law rule was intentionally abandoned by the courts and replaced by the dichotomy with respect to the payment of tax liabilities by a debtor, either in general, or specifically when those payments are made in the context of a bankruptcy reorganization.

B. Reliance on a "voluntary-involuntary dichotomy" in tax cases was the result of unintentional misapplications, not abrogation, of the traditional rules.

When the issue of application of payments was presented to the courts in the context of taxation, the courts naturally and properly looked to the same common law rules.[1]

In *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964), the Court of Appeals held that the bankruptcy court lacked jurisdiction to direct the I.R.S. how to apply monies deposited with the court but not belonging to the bankrupt estate. In *O'Dell*, excess proceeds realized from a Sheriff's foreclosure sale of real property owned jointly by the bankrupt and his wife and not in the bankrupt's estate, as well as monies realized by the I.R.S. after seizure and sale of another parcel of realty, also not in the bankrupt's estate, were deposited into the

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[1] No statute preempts the common law regarding application of payments or authorizes the I.R.S. to promulgate regulations which would curtail a tax debtor's otherwise existing rights.

bankruptcy court upon its order. On denying a motion of the bankrupt's wife that the impounded money be paid over to the I.R.S. only after certain assets of the bankrupt estate were used to satisfy a portion of the tax debt and then only to the extent of the penalty owing, the bankruptcy court ordered the money turned over to the I.R.S. and ruled that the funds were not an asset of the bankrupt estate and that it lacked jurisdiction to compel any specific allocation of the proceeds. That result appears correct under the common law rules if viewed as a refusal by the court to exercise control over property not properly deposited with it. On appeal, the Tenth Circuit Court of Appeals affirmed the bankruptcy court, but used reasoning appearing inconsistent both internally and with the authorities relied upon. The Court of Appeals there reasoned that the jurisdiction of the bankruptcy court over the funds was proper since the parties had invoked and consented to it. The court then addressed the application issue, saying:

> "As a general rule, a debtor voluntarily paying his debt may direct application of his money to such items or demands as he chooses. 70 C.J.S., Payment, § 52, pp. 257-259; 40 Am.Jur., Payment, § 110, pp. 792-793. But, such is not the case where, as here, the payment is made involuntarily as in an execution or judicial sale. 70 C.J.S., Payment, § 51, pp. 256-257; 40 Am.Jur., Payment, § 139, pp. 811-812."

Id. at 456. The Court quoted only *part* of the common law rule and therefore wrongly expressed and interpreted it. As previously discussed, C.J.S. and AM. JUR. both relied upon *Orleans Nat. Bank v. Moore* for the proposition cited and all three authorities clearly express that, in the case of "involuntary" payments, it is *neither* the debtor *nor the creditor*, but indeed *is* the court, to properly determine application of the payments made

under its order. Having determined that the exercise of the bankruptcy court's jurisdiction over the monies was proper, the very authorities cited by the Court suggest that the Court was under a duty to apply the monies in accordance with equitable principles.[2]

A few years later, the Tax Court, in *Amos v. Commissioner*, 47 T.C. 65 (1966), held that amounts received by the I.R.S. pursuant to administrative levies could be applied between assessments of tax, penalties and interest as the I.R.S. chose. The Tax Court acknowledged the general rule as well as the historical limitations to its application, saying, with respect to the latter:

> "In many jurisdictions, including Illinois where these payments were made, it is held that the rule giving the debtor or creditor the right to direct the application of *voluntary* payments has no application to *involuntary* payments." *Id.* at 68 [emphasis by court].

In a footnote, the court recognized a critical distinction between the "involuntary" exception to the general rule and the case of an administrative levy then before it, saying:

> "Usually cases applying [the rule denying the debtor and *creditor* the right to direct the application of involuntary payments] involve judicial proceedings, such as bankruptcy, receivership, probate, or mortgage and lien foreclosures, in which the sale of property is under the umbrella of the court's supervision. In such situations the

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[2] Another possible and reasonable theory for the result reached could have been a declination of the Court to make an allocation in the exercise of its discretion, *i.e.*, to intentionally allow the payment to be made unallocated. Such was not the reasoning of the Court, however.

> court, in its discretion, determines the application of payments according to legal and equitable principles. There is no court supervision or control over payments received by a district director as a result of administrative collection of Federal taxes by levy or distraint." *Id.* at 68 & n. 3. [emphasis added].

The *Amos* Court did recognize the significance of control and acknowledged court-directed application of court-controlled funds.

Applying the historical common law approach and analysis of control, the court's decision was appropriate and consistent with traditional reasoning. From the time of the levy, the taxpayer/debtor lost control of, and therefore the right to designate the application of proceeds from, the property seized or levied upon. There being no court involvement or other intermediary exercising legitimate control over the property or funds, the right of control and concomitant right to direct application devolved upon the I.R.S.

The *Amos* Court's discussion was not without some confusion, however. It appears that the confusion stemmed at least in part, from the *O'Dell* decision, which the court recognized as an aberration. The *Amos* Court mentioned a "minority view" that "some jurisdictions give the creditor the right to direct the application of involuntary as well as voluntary payments." *Amos* at 69. Recognizing (but not so stating) that the *O'Dell* recitation of the general rule was incorrect, the Court suggested that the *O'Dell* court had "adopted" the minority view with respect to taxes. Clearly, however, that was not the case. To that time, *no* rule, including the "minority view," gave debtors discretion in the application of voluntary payments and creditors unfettered discretion in the application of "involuntary" payments. As previously discussed, the *O'Dell* discussion was a misguided or

incomplete attempt to apply the traditional "majority" rule. Possibly as a result of not being entirely comfortable relying solely on *O'Dell*, the *Amos* Court also claimed support for its conclusion from *Standard Oil Co. v. United States*, 5 F.Supp 976 (Ct.Cl. 1934), *cert. den.*, 293 U.S. 599, and *Matter of Griffitts Paving Co., Inc.*, 54-2 U.S.T.C. ¶9646 (E.D. Tenn. 1954). Those two cases were (and are here), however, inapposite. Those cases primarily involved the issue of the I.R.S.'s right to apply overpayments in one or more years to deficiencies in one or more other years under statutory authority. The issue there presented was one of statutory construction and Congressional intent, rather than the applicability and application of the common law. Unfortunately, the *Amos* Court failed to realize that all the support it needed was available in the longstanding common law rules.

Application of the rules in the context of tax cases was further explored in *Muntwyler v. United States*, 703 F.2d 1031 (7th Cir. 1983). In *Muntwyler*, the I.R.S. filed a claim for trust fund and non-trust fund taxes with a non-judicial trustee/assignee for the benefit of the taxpayer/debtor's creditors. The trustee made payments to the I.R.S. directing their application to trust fund taxes. The I.R.S. accepted the money, but refused to honor the direction regarding application of it. The district court upheld the allocation, finding the *assignee's* payment "voluntary." The Seventh Circuit also applied the "voluntary-involuntary dichotomy," but again to the *assignee's* payment, stating:

> "The sole question, therefore, is whether the district court correctly held that the assignee's payment was voluntary." *Id.* at 1033.

The I.R.S. argued that the payment was involuntary (presumably as to the *debtor*) because it was made pursuant to an I.R.S. administrative claim filed with a

third party assignee, relying on language in *Amos*. The court disagreed, however, saying:

> "The distinction between a voluntary and involuntary payment in *Amos* and all other cases is... the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy." *Id.* at 1033. [emphasis by the court].

The Court there enlisted support for its conclusions from the I.R.S.'s own Policy Statement P-5-60, Int. Rev. Manual (CCH) 1305-15, that taxpayers have "no right of designation in the case of collections resulting from *enforced collection measures*." [emphasis added by court in quoting Policy Statement]. The court held that "merely filing a claim for back taxes [was not] an 'enforced collection measure.'" *Muntwyler*, 703 F.2d at 1032. Again, the significance of the "seizure" language appears to be the clear transfer of control over the seized property resulting from such action.

It is significant that while all prior cases applying the "voluntary-involuntary dichotomy" examined the *taxpayer's* volition, here the court focused on and was persuaded by I.R.S. action or inaction, *i.e.*, by the absence of a *seizure* by the I.R.S., noting that the only action of the I.R.S. was to file a claim.

Common law analysis takes a different path to the same result and also suggests the analytical deficiencies which have, over the years, produced so much litigation over the same or similar issues arising in the Chapter 11 bankruptcy context. Upon its assignment to the trustee, the *Muntwyler* debtor lost control over his property and with it the right to designate how the trustee's payments would be applied. The payment was, in a sense, "involuntary" as to the taxpayer. Thus, there was some logic in the I.R.S. argument to that effect. Control, however, vested in the trustee, not the I.R.S. The trustee/as-

signee, therefore, having title to and control over the property (albeit subject to his duties as assignee for the benefit of creditors), had the legal right and power to direct application of payments made. It was necessarily the latter fact of assignee control, rather than the former fact of the debtor's loss of control, that the court focused on (in saying that the *assignee's* payment was voluntary) and which lead to the result. By understanding, acknowledging and applying the traditional rules, the same appropriate result could have been reached without the laborious inquiry concerning volition. Although couched in terms of volition, the issue has always been one of the simple property right of "control."

C. Attempts to apply the Voluntary-Involuntary Dichotomy in the Chapter 11 Context have resulted in an unworkable game of semantics.

The voluntary-involuntary dichotomy is not only inconsistent with the analytically sound common law rules and any logical evolution therefrom, it doesn't work.

Insistence that remittances be classified in one of only two ways, each having rigid and opposite results and implications, fails to allow the law sufficient flexibility to work justice and is neither required by statute nor consistent with the historically applied common law rules. The terms "voluntary" and "involuntary," themselves subjective terms to begin with, are, under the dichotomy, elevated from descriptive labels to determinative criteria, and legal reasoning has been precluded or reduced to a semantical game.

The semantic nature of the voluntary-involuntary dichotomy can be demonstrated as follows. Certain

payments, such as those made in the context of a Chapter 11 proceeding, are not clearly "voluntary" or "involuntary," having some characteristics generally found in situations described by each term. Courts have analyzed and weighed the various attributes of the Chapter 11 context in attempts to "fit" the "right" label. *See, In re Energy Resources, Co., Inc.*, 871 F.2d at 228-229. Since a payment in such a "gray area" will have characteristics of both the agreeably "voluntary" and the agreeably "involuntary," one could answer "no" to the question "is the payment voluntary?" (thereby calling it "involuntary"); but could also answer "no" to the converse (concluding it to be "voluntary"). Thus, in applying the voluntary-involuntary dichotomy to payments falling within the "gray area," whether such payments are considered voluntary or involuntary will depend more on how one couches the question and the subjective evaluation of definitional characteristics than on any substantive distinctions in reason, logic and justice which the law, presumably, seeks to make. Payments made in the Chapter 11 bankruptcy context fall within that "gray area" and therefore fall victim to the faulty analysis inherent in the dichotomy. Both the First Circuit below and the Ninth Circuit in *Technical Knockout Graphics* noted the struggle over fitting the dichotomy's labels and the resulting split in the circuits. *In re Energy Resources, Co., Inc.*, 871 F.2d at 229, *Technical Knockout Graphics*, 833 F.2d at 801-802. To the extent the courts have relied on the voluntary-involuntary dichotomy as a "simplified," "bright-line" rule for determining the right to direct application of tax payments, the rule has proved neither simple and bright nor just and efficacious.

In struggling over which of only two allowable labels a given remittance should be given ("voluntary" or "involuntary") so as to decide whether the taxpayer or the I.R.S. can direct its application, the dichotomy fails

to recognize (as the common law did) that the ability to direct application of payments does not *have* to lie solely and exclusively within the whim of either of two litigants. By focusing on two labels rather than on control over property, the dichotomy ignores that there are interim points on the voluntary-involuntary continuum and there is a necessary and proper role for courts in determining just application of payments among liabilities when such payments are made pursuant to court order or under court supervision.

In applying the dichotomy, Courts have resolved the immediate disputes but not the real issue. The opportunity is now presented to return to the analytically sound common law rules.

D. Nothing in the Bankruptcy Code divests debtors in a Chapter 11 reorganization, of their common law right to designate the application of payments. If there is such a divestiture, the ability to designate rests with the court, not the creditor (I.R.S.).

Upon commencement of their Chapter 11 proceedings, estates comprised of all the debtors' respective property and rights therein were created. 11 U.S.C. §541. The Bankruptcy Court acquired jurisdiction over all such property. 28 U.S.C. §1334(d). As debtor in possession, Newport Offshore acquired or retained all rights and interests in its property, subject to its duties as provided by law, its plan of reorganization, and to the Court's jurisdiction; the ERCO Liquidation Trust acquired all rights and interests in Energy Resources Co., Inc.'s property subject to similar duties and jurisdiction. 11 U.S.C. §1107(a). Newport Offshore and the ERCO Liquidation Trust were, as a result, in positions

similar to that of the *Muntwyler* debtor and assignee, combined.

No provision of the law divested either Newport Offshore or the ERCO Liquidation Trust of its common law right to designate how payments made to creditors would be applied. Although the exercise of that right may have been subject to review by the bankruptcy court, under no reasonable theory was the right to designate the application of payments automatically divested from either debtor and passed to the I.R.S. as creditor. There is no basis for a creditor's rights in this regard to be any greater in the bankruptcy context than outside it.

The law requires that any proposed plan of reorganization meet certain requirements and make certain provisions. 11 U.S.C. §1123. The debtors' plans met those requirements. A plan may, however, also contain "any other appropriate provision not inconsistent with the applicable provisions of [Title 11]." 11 U.S.C. §1123(b)(5). If a debtor's plan meets the requirements of the law, the Court is required to confirm it. 11 U.S.C. §1129(a) and (b)(1). Thus, the Court is given specific authority to review and confirm plans with provisions designating how payments to creditors should be applied if they otherwise meet the statutory requirements. There was nothing improper in the Court's approval of Newport Offshore's plan.

Upon confirmation of their respective plans, all property of the Energy Resources Co., Inc. estate, including all rights and interests therein, was vested in the ERCO Liquidation trust, subject only to the terms and conditions of the trust and the plan, and all property rights of Newport Offshore reverted to it, subject only to the terms and conditions of its plan. 11 U.S.C. §1141. Debtors acting under a plan retain and exercise significant control over their property. There is no longer an

estate or other specific funds or property held in trust under the court's umbrella.[3] There is no basis for a debtor's common law right to designate application of payments to disappear in the Chapter 11 context. If, under some theory, the right to designate the application of payments is divested of a debtor upon the filing of its bankruptcy petition, the right would revert to it upon confirmation of a plan, entitling the debtor to designate how payments would be applied whether or not stated in its plan, so long as such designation was not inconsistent with that plan.

If, on some basis, a debtor's common law right to designate application of payments is divested upon filing a petition in bankruptcy and not revested upon confirmation, historical authorities suggest that where ultimate control over property is subject to jurisdiction of a court, any allocations of payments therefrom are likewise to be made *exclusively* by the court. *See, e.g., First Nat. City Bank v. Kline*, 439 F.Supp. 726, 729 (1977), where payments made pursuant to bankruptcy were later allocated by the Court *pro rata*.

E. Policy considerations do not militate against the application of the common law rules in the Chapter 11 context.

One of the apparently significant influences on the Courts of Appeals for both the Ninth Circuit and the Third Circuit in *Technical Knockout Graphics* and *Ribs-R-Us*, respectively, was the I.R.S. argument, also presented here, that the policies underlying Section 6672 of

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[3] In that way, a Chapter 11 reorganized debtor is in a significantly different position than, *e.g.*, a debtor undergoing a liquidation bankruptcy.

the Internal Revenue Code of 1986 (26 U.S.C.)[4] would be undermined by the allocations proposed by the debtors there, or that such allocations "could defeat the priority scheme established by Congress." *Technical Knockout Graphics*, 833 F.2d at 803. *See, also, In re Ribs-R-Us, Inc.*, 828 F.2d at 203-204. There are at least three analytical problems with that approach.

First, the issue of whether and to what extent a debtor might abuse an otherwise available right so as to conflict with statutory policies addresses the substance of the proposed allocations and is irrelevant to whether the debtor is granted such a right to begin with. In the Chapter 11 bankruptcy context, any concerns over the *substance* of proposed allocations can be evaluated by the exercise of the Court's jurisdiction and discretion. Thus, such policy considerations do not call for the wholesale abrogation of debtors' historical common law rights.

Second, as the Court below noted, I.R.C. §6672 does not express or imply a policy that "responsible officers" should make the Government whole for all tax liabilities and therefore does not support the I.R.S. position. *See, In re Energy Resources Co., Inc.*, 871 F.2d at 232-233. I.R.C. §6672 concerns itself only with "trust fund" taxes, *i.e.*, taxes withheld from wages. That section expresses an intent and policy that *those* taxes are important enough to be collected to the greatest extent possible. Since it is those very taxes which the debtors here seek to pay (not avoid), such an allocation is entirely consistent with the statutory scheme. It is the I.R.S., not the debtors, which seeks to abuse I.R.C. §6672 by using it to

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[4] The Internal Revenue Code of 1986, formerly known as the Internal Revenue Code of 1954, was redesignated pursuant to Section 2 of the Tax Reform Act of 1986 (P.L. 99-514) and is hereinafter referred to as "I.R.C."

support its own (not Congress's) policy of ensuring trust fund taxes are paid *last*. *See, In re Energy Resources Co., Inc.*, 871 F.2d at 232.[5]

Finally, the I.R.S.'s argument is permeated with the implication that "responsible officers" of corporations owing trust fund taxes are "bad guys" who misappropriated government funds held in trust. The suggestion is naive and has little foundation in reality. As a practical matter, a corporation on the verge of bankruptcy is unlikely to have sufficient funds from which to create any trust *res* in the first place, let alone misappropriate it. Lacking funds sufficient for a gross payroll, a corporate officer wishing to keep the business alive will use all available cash to pay *net* payroll. The "withheld" taxes, constituting the difference between gross payroll and net payroll, are not misappropriated- they don't exist. As new funds come into the business, they are used to pay newly maturing obligations which threaten immediate cessation of business. No trust is imposed on those newly acquired funds. *See, Slodov v. United States*, 436 U.S. 238 (1978). When the company's payroll tax deposit becomes due, the business is without funds sufficient to pay the amounts fictionally "withheld" as well as the employer's share of social security (FICA)

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[5] It should also be noted that, as a matter of practice, the I.R.S. does not allocate payments when it receives them. It merely posts the payment to the taxpayer's account for a particular period. It will even, on occasion, reapply the payment to a different period if deemed in its best interest. Any allocation takes place only when the issue arises. Thus, the I.R.S. has claimed and now seeks unfettered discretion to take any position it wants with respect to allocation, at any time, as best suits its then perceived needs, and to change that position at will as the perceived need changes. Uncircumscribed and unreviewed, such is an awesome and unwarranted power, and one neither expressly nor implicitly granted.

taxes also due. The optimistic corporate officer anticipates a "better time" when the entire obligation can be satisfied. If that time never comes, the obligation grows.

Although one may not condone their actions, such businessmen and women have hardly misappropriated Government funds; and they are unlikely to be any more deterred from their actions by the potential denial of the corporation's common law right to allocate payments in a Chapter 11 bankruptcy than they are currently deterred by personal liability under I.R.C. §6672 for amounts fictionally withheld.

CONCLUSION

In determining who has the right and authority to determine how payments made to the I.R.S. will be applied as among various tax liabilities, the long-standing common law rules apply, not a recently created label-dependent dichotomy. The common law recognizes the right of a person to control his own property and therefore how it is to be applied when paid to another. Nothing in the Bankruptcy Code divested the debtors here of that property right. Since the debtors retained that right, its exercise in a Plan of Reorganization (in the case of Newport Offshore, Ltd.) or subsequently (in the case of Energy Resources Co., Inc., by the ERCO Liquidation Trust) was proper, and consequently the orders of the courts below allowing such exercises of the right were proper. If the debtors were divested of their right to designate, the right devolved upon the Bankruptcy Courts, not the I.R.S. as creditor, in which case the Bankruptcy Courts' orders requiring the I.R.S. to allocate the payments as directed were proper.

It follows that the First Circuit below should be affirmed and the designation of Newport Offshore in its plan of reorganization, and that of the ERCO Liquidation Trust in its post confirmation payments, to apply payments to the I.R.S. first to trust fund taxes, be allowed to stand.

Respectfully submitted,

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